Bell, D N F and Danson, M W and Duignan, J and Glassford, M E and Kirwan, F X and McGilvray, J W and Simpson, D R F and Wingfield, Alison A. (1977) Towards Full Employment and Price Stability? [Review] ,

The World Economy : Towards Full Employment and Price Stability?

In a major study*, commissioned by the OECD, and published in June of this year, a group of economists have set down their analysis of the past, present, and likely future performance of the world economy. It is perhaps inevitable that a report which deals with as heterogeneous a subject as the world economy tends to be somewhat lean on policy prescriptions. Nonetheless, this shortcoming is more than compensated by an extensively documented analysis of developments in the world economy over the past decade. The strength of the analysis lies in the breadth of its perspective. All too often, it has been assumed that the problems of the world economy are solely due to the OPEC inspired oil price rise of the winter of 1973-74. This view has persisted in spite of the publication of numerous studies which have estimated the full impact of the price rise as an increase of perhaps 3-5% in the price level of most industrial economies. The OECD study places the OPEC action in perspective, and identifies the roots of the recent recession as stretching at least a decade into the past. Furthermore, it leaves little doubt that policy errors from the late 1960's onwards contributed to the severity of the downturn. For this reason alone, it is worth looking at the OECD thesis in some detail.

From the mid sixties onwards, it became obvious that the American involvement in Vietnam was likely to be both extensive and long term. However, its impact on the American economy was substantially underestimated, and its broader effects on the world economy scarcely considered. Under the pressure of heavy military spending the American balance of payments ran substantial deficits in the years 1965-67. In the fixed exchange rate world of the sixties, the counterpart of the American deficit was the expansion in the money supply of her trading partners. As the pressure of aggregate demand throughout the world began to rise, inflation started to creep upwards. Strong labour unrest in Europe in 1968 - the so-called wage explosion - reinforced this trend. The boom was restrained in 1969 by deflationary action taken mainly in the

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* *Towards Full Employment and Price Stability*. Paul McCracken, Guido Carli, H Giersch, A Karaosmanoglu, R Komiya, A Lindbeck, R Mayalin, R Matthews. OECD, Paris, June 1977 £7.80

United States, but inflationary expectations had already been aroused and were influencing wage negotiations in many countries. The subsequent slowdown of inflation in 1970-71 did little to dispel such expectations, and the breakdown of the Bretton Woods fixed exchange regime in mid-1971 provided the means to validate these varying inflationary tendencies. The world economy was headed for a boom.

1972 was an election year in Germany, Japan and the US and it appears that the level of aggregate demand in these three major economies was boosted somewhat to secure the re-election of the incumbent administrations, an important factor in the subsequent synchrenisation of the business cycles. Over the eighteen months to mid-1973, the world experienced the most rapid upswing of the post-war period, What was outstanding was, not the levels of capacity utilisation reached, which appear to have been lower than in 1968, but the speed of the expansion, Monetary policy was generally permissive, and inflation-proof assets such as real estate and gold began to rise rapidly in price. Widespread crop failures in the Eastern world reinforced the inflationary trend as food prices rose. Rising pressure of demand lifted raw material prices and,in time,wages began to catch up. The wage price spiral was to become institutionalised through indexation and threshold agreements in many countries. Faced with unprecedently high rates of inflation combined with large margins of unutilised resources, expecially in the labour market, the major OECD countries had adopted a contractionary stance by mid-1973. Thus, in the months preceding the oil crisis, real GDP growth slowed markedly, but the same was not true of inflation which was buoyed upwards as wage bargains attempted to compensate for past price rises, and as inflationary expectations rose further. Nonetheless, some components of generalised inflation, such as commodity prices had already begun to decline.

The quadrupling of oil prices had three main effects on the developed countries. It weakened their collective current account balance of payments, it further fuelled their inflation, and it reinforced the contractionary effects of domestic policies. While the effects were clear, the appropriate policy response was not. In many cases, governments faced with renewed inflationary pressures, adapted a still more deflationary stance than heretofore. To this extent, the OPEC action merely deepened the recession which was already breaking over the developed world. The deterioration in the terms of trade facing the non-oil producing states was equivalent to a reduction in their real incomes. Yet how was this reduction to be distributed amongst the "social partners"? In the short run it was absorbed by profits - for three reasons. Price controls depressed profit margins as input prices rose, wage increases in late 1973 and into 1974 were substantial, even in low inflation economies such as Germany, and the historical cost accounting techniques then in use were inappropriate for an inflationary period. Over the somewhat longer term labour income was also affected, as the numbers employed fell and as real earnings fell for those in employment. These effects were reinforced as inflationary wage settlements came into conflict with rigid money supply regimes in countries such as Germany. In many cases, it was the marginal members of the labour force, such as school leavers and migrant workers who bore the brunt. Countries differed in the time path of their reactions. In the US and Germany the adjustment to the real income fall was accomplished quite sharply, others such as Britain and France tried to maintain the pre-crisis level of real incomes, and merely succeeded in accumulating budgetary and balance of payments deficits and in postponing the necessary adjustments.

The severity of the recession was becoming apparent by mid-1974, by which time policy was again becoming expansionary in those countries which deflated earliest, the US, Germany and Japan. Meanwhile, the volume of world trade was sustained somewhat by strong demand from less developed countries flush with the proceeds of the commodity price boom of the previous year. A fragile, and by no means world-wide, recovery was initiated in mid-1975 as reflationary packages began to take effect, and as deferred purchases of consumer durables became important in the US and Germany. But by early 1976, the strength of the recovery was somewhat in doubt as inflation appeared to rekindle, and as budgetary and balance of payments constraints began to inhibit further reflationary action in the majority of countries. This period saw considerable activity in foreign exchange markets as parities adjusted with a lag to account for variations in national inflation rates over the previous few years. Those industries whose currencies suffered sharp depreciation, such as Italy, France and the UK saw the prospect of single digit inflation recede even farther into the future.

Then began the present period of export led stagnation. Governments everywhere, with the exception of the US refrained from stimulating domestic demand for budgetary and balance of payments reasons, and waited instead for export demand to prime their economies. However, the only and woefully inadequate source of export demand was the US, and so began the "pause" of mid-1976. As the year progressed calls were made even more stridently that those countries enjoying a strong balance of payments position, i.e. Germany and Japan, should reflate domestic demand and so suck in imports. This call is also made in the OECD report, and recent policy measures would suggest that it is now being heeded. However, the cautious policy stance currently being adopted would suggest that the prime validating factor of the 1972-73 boom and the 1974-75 recession, (the two must be looked at together), ie. excessive expansion of monetary aggregates over the past decade, is unlikely to be repeated.